No. 20–1930

In the

United States Court of Appeals

For the First Circuit

IN RE: THE FINANCIAL OVERSIGHT AND MANAGEMENT BOARD FOR PUERTO RICO, AS REPRESENTATIVE FOR THE COMMONWEALTH OF PUERTO RICO; THE FINANCIAL OVERSIGHT AND MANAGEMENT BOARD FOR PUERTO RICO, AS REPRESENTATIVE FOR THE PUERTO RICO HIGHWAYS AND TRANSPORTATION AUTHORITY; THE FINANCIAL OVERSIGHT AND MANAGEMENT BOARD FOR PUERTO RICO, AS REPRESENTATIVE FOR THE PUERTO RICO ELECTRIC POWER AUTHORITY (PREPA); THE FINANCIAL OVERSIGHT AND MANAGEMENT BOARD FOR PUERTO RICO, AS REPRESENTATIVE FOR THE PUERTO RICO SALES TAX FINANCING CORPORATION, a/k/a Cofina; THE FINANCIAL OVERSIGHT AND MANAGEMENT BOARD FOR PUERTO RICO, AS REPRESENTATIVE FOR THE EMPLOYEES RETIREMENT SYSTEM OF THE GOVERNMENT OF THE COMMONWEALTH OF PUERTO RICO; THE FINANCIAL OVERSIGHT AND MANAGEMENT BOARD FOR PUERTO RICO, AS REPRESENTATIVE FOR THE PUERTO RICO PUBLIC BUILDINGS AUTHORITY

Debtors

(*For continuation of caption see inside cover.*)

On Appeal from the U.S. District Court for the District of Puerto Rico, San Juan, Nos. 17–03283–LTS, 17–03567–LTS (Swain, J.)

BRIEF FOR THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION AS AMICUS CURIAE IN SUPPORT OF APPELLANTS' BRIEF AND REVERSAL

(*Counsel listed inside cover.*)

November 4, 2020

———————————

ASSURED GUARANTY CORPORATION; ASSURED GUARANTY MUNICIPAL CORPORATION; AMBAC ASSURANCE CORPORATION; THE FINANCIAL GUARANTY INSURANCE COMPANY; NATIONAL PUBLIC FINANCE GUARANTEE CORPORATION,

Movants-Appellants,

v.

FINANCIAL OVERSIGHT AND MANAGEMENT BOARD FOR PUERTO RICO, AS REPRESENTATIVE FOR THE COMMONWEALTH OF PUERTO RICO; THE FINANCIAL OVERSIGHT AND MANAGEMENT BOARD FOR PUERTO RICO, AS REPRESENTATIVE FOR THE PUERTO RICO HIGHWAYS AND TRANSPORTATION AUTHORITY,

Debtors-Appellees,

PUERTO RICO FISCAL AGENCY AND FINANCIAL ADVISORY AUTHORITY,

Respondent-Appellee,

OFFICIAL COMMITTEE OF UNSECURED CREDITORS; AMERINATIONAL COMMUNITY SERVICES, LLC, as servicer for the GDB Debt Recovery Authority; CANTOR-KATZ COLLATERAL MONITOR LLC, as collateral monitor for the GDB Debt Recovery Authority,

Interested Parties-Appellees.

———————————

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Federal Rule of Appellate Procedure 29(a)(4)(A), the Securities Industry and Financial Markets Association ("*SIFMA*") states that it has no parent corporation and that no publicly held corporation owns more than ten percent of its stock.

RULE 29 STATEMENTS

Pursuant to Federal Rule of Appellate Procedure 29(a)(3), SIFMA states that a motion for leave to file accompanies this brief. Pursuant to Federal Rule of Appellate Procedure 29(a)(4)(E), SIFMA states that: no party's counsel authored the brief in whole or in part; no party or party's counsel contributed money that was intended to fund preparing or submitting the brief; and no person, other than amicus curiae, contributed money that was intended to fund preparing or submitting the brief.

Dated: November 4, 2020

/s/ Laura E. Appleby
Laura E. Appleby
Counsel for Amicus Curiae

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INTEREST OF AMICUS CURIAE

The Securities Industry and Financial Markets Association ("*SIFMA*") represents the shared interests of hundreds of securities firms, banks, and asset managers—including many that actively participate in the municipal revenue bond market.[1] SIFMA serves as the regional member of the Global Financial Markets Association for the United States. It maintains offices in New York, New York and Washington, D.C.

SIFMA advocates for a strong financial industry that cultivates opportunity, job creation, and growth and simultaneously builds trust and confidence in markets. Relevant here, SIFMA aims to foster a robust, stable, and lasting municipal bond market. Such a market enables SIFMA's members to confidently invest in and finance infrastructure, vital services, and other projects that empower local municipalities to compete on a global scale.

Stated differently, a robust bond market allows municipalities across the United States and its territories—including Puerto Rico—to fund projects and services despite many demands on those municipalities' finite resources. A robust municipal bond market is thus critical to the financial stability of local governments.

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[1] The SIFMA Asset Management Group ("*AMG*") is the voice of buy-side participants in the securities industry and broader financial markets. AMG's members are management firms with more than $34 trillion in assets under their control. The clients of AMG member firms include government pension funds, ERISA plans, registered investment companies, and individual accounts.

But to be robust, the municipal bond market must inspire investor confidence. And to inspire investor confidence, the municipal bond market must be reliable. With two- to three-decade repayment periods, municipal revenue bonds provide holders with reliable, fixed payments from a guaranteed stream of revenues. This allows investors both to invest with the confidence that their repayment isn't directly tied to a municipality's finances and, similarly, to focus their diligence efforts on a particular project rather than an entire municipality.

The District Court found that bondholders' security interest in revenues and a dedicated tax stream (that the Puerto Rico Highways and Transportation Authority (the "HTA") pledged in connection with bond issuances) did not attach until those revenue streams were actually deposited with the fiscal agent responsible for paying bondholders. That conclusion upended a fundamental market expectation: that a pledge of revenues and excise taxes in connection with a municipal-bond issuance secures the repayment of principal and interest on those bonds, and that this pledge is valid when the municipality obligated on the bonds receives the revenues or excise taxes (as opposed to when it transfers the revenues or dedicated taxes for payment to bondholders). The District Court also found that, despite a law requiring that a dedicated tax stream be used only to pay principal and interest on a bond issuance, those dedicated taxes could be diverted for other uses. This is fundamentally opposed to market expectations on which investors have relied.

The outcome of this appeal is thus of core importance to SIFMA's membership. If the Court affirms the decision below, it will harm the municipal revenue bond market and the issuing municipalities by raising questions about the security and predictability of those investments. But if the Court reverses the decision below, it will confirm longstanding, fundamental market-wide expectations about municipal revenue bonds.

SUMMARY OF ARGUMENT

Municipalities have but a few tools to finance the services they provide and the projects they undertake. They can raise taxes, impose fees and other charges, receive funds from federal and state governments, and, importantly, issue financial instruments such as bonds. American municipalities have used the latter tool for more than two hundred years. While municipal finances fluctuate with macroeconomic trends, municipal revenue bonds have remained a consistent source of financing. Through municipal bonds, municipalities can borrow funds to invest in needed infrastructure and equipment today but pay back investors at a reasonable rate of interest over time, and at an interest rate that is not tied solely to the general financial health of the municipality. The repayment period also permits municipalities to spread out costs over the life of the infrastructure, such that the costs are paid for by those enjoying its use.

Municipal bonds are essential public-finance tools. That is especially so for revenue bonds. Revenue bonds are secured by and paid through the revenue stream from the projects they finance—like hospitals, airports, and toll roads—or through a dedicated tax stream. As a result, they do not impose an additional burden on taxpayers. This "revenue pledge" also benefits investors: it supports the obligation they will be repaid despite financial difficulties the issuing municipality may face. Indeed, revenue bonds are generally non-recourse bonds, meaning that, in many cases, holders cannot pursue the issuing municipality's general revenues in the event of a default.

The market has understood revenue bonds to operate in this manner for more than two centuries. Government agencies, legal commentators, and historians share this understanding. Revenue bonds accordingly boomed in popularity and now constitute more than half of the $3.9 trillion municipal bond market. And yet, despite this widely held understanding, the District Court found that Appellants acquired a security interest in the toll revenues and dedicated excise tax streams arising from projects financed by the HTA bonds only when those revenues were actually deposited in the accounts of the fiscal agent who pays the bonds.[2] This conclusion

[2] *In re The Fin. Oversight & Mgmt. Bd. for Puerto Rico, as representative of The Commonwealth of Puerto Rico*, Opinion & Order, Dkt. No. 13541, at 36 (July 2, 2020) (the "*Opinion and Order*").

grossly misreads the underlying bond documents—and grossly misunderstands the function of the municipal bond market and the expectations of its participants.

The District Court's decision contravenes well-settled understanding about the security and reliability of municipal revenue bonds and thrusts confusion upon that market. It therefore risks increasing municipalities' borrowing costs (or reducing the financing available to them) and upsetting the portfolios and expectations of bondholders—more than two-thirds of whom are individuals, and all of whom seek reliability and predictability when investing in municipal securities. The District Court's Opinion & Order is wrong as a matter of law and bad as a matter of policy. The Court should not let it stand.

ARGUMENT

I. REVENUE BONDS ARE A NECESSARY SOURCE OF MUNICIPAL FINANCING

> Call it municipal exceptionalism: this market is different. More than corporate debt or securities, municipal bonds are a means to an end; they promote the general welfare and improve quality of life . . . To the issuers, dealers, counsel, consultants and regulators, the municipal market is something to be passionate about.
>
> —Dr. Kenneth Durr, *The Municipal Securities Rulemaking Board Gallery on Municipal Securities Regulation—Introduction*, Securities and Exchange Commission Historical Society (Dec. 1, 2015).[3]

[3] *Available at* http://www.sechistorical.org/museum/galleries/mun/index.php (last accessed Nov. 3, 2020).

Municipalities may feel stuck between a rock and a hard place as of late. Across the country, populations are becoming more urbanized. These populations demand that municipalities provide greater, better services. And essential infrastructure requires costly upkeep. Municipalities have but a few sources from which to draw the funding necessary for the services they provide. Municipalities can raise taxes. They can receive federal and state aid. They can impose fees and other charges.

And, importantly, they can sell financial instruments such as bonds—including those that use future revenues to pay for needed infrastructure projects today.[4] Revenue bonds are an equalizing force—so long as the revenues or dedicated taxes pledged to support a project (whether it, for instance, is a sewer system or a municipal health center) are sufficient, the income level of the demographic served does not matter. But all of this depends on a consistent, predictable market, which, in turn, depends on consistent legal application of principles accepted by revenue market participants.

[4] Revenue bonds are also a useful tool insofar as they permit a municipality to build needed infrastructure without disproportionately burdening current residents with the project's entire costs, where the project will also benefit future populations.

II. THE MUNICIPAL BOND MARKET "REPRESENTS AN INCREASINGLY IMPORTANT PART OF THE U.S. CAPITAL MARKETS"

Perhaps because municipal bonds provide essential financing to state and local governments—including United States territories, like Puerto Rico—municipal bonds have come to play an increasingly important role in our country's economy. "Municipal bonds are debt securities issued by states, cities, counties and other governmental entities to finance capital projects . . . and to fund day-to-day obligations." U.S. Sec. & Exch. Comm'n, *Municipal Bonds*, http://www.sec.gov/answers/bondmun.htm (last accessed Nov. 3, 2020); *see also* U.S. Sec. & Exch. Comm'n, *Report on the Municipal Securities Market* at 5 (July 31, 2012) ("*Municipal Securities Report*").[5] Municipalities traditionally offer two types of bonds: general obligation bonds and revenue bonds. *See* H.R. Rep. No. 100–1011, at 3 (Sept. 14, 1988), *reprinted in* 1988 U.S.C.C.A.N. 4115, 4118 ("*House Report*"). This appeal concerns the latter type.

The municipal bond market has been referred to drolly as the "newest old market." Dr. Kenneth Durr, *The Municipal Securities Rulemaking Board Gallery on Municipal Securities Regulation—The Newest Old Market*, Securities and Exchange Commission Historical Society, http://www.sechistorical.org/museum/galleries/mun/mun_06a_emma.php (last accessed Nov. 3, 2020). One of the earliest

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[5] *Available at* https://www.sec.gov/files/munireport073112.pdf (last accessed Nov. 3, 2020).

issuances of a revenue bond happened in 1407, when the Casa di San Giorgio was formed to save the Republic of Genoa from financial ruin. *See, e.g.*, Clayton P. Gillette, *Can Public Debt Enhance Democracy?*, 50 Wm. & Mary L. Rev. 937, 939 (Dec. 2008).

Closer to home, municipal "[d]ebt securities were the earliest financial instruments to trade in America." Dr. Kenneth Durr, *The Municipal Securities Rulemaking Board Gallery on Municipal Securities Regulation—Two Centuries of Municipal Finance, Share in the Growth*, Securities and Exchange Commission Historical Society, http:// www.sechistorical.org/ museum/ galleries/ mun/ mun02a_ share_ growth.php (last accessed Nov. 3, 2020). Massachusetts, in 1751, was the first to issue a municipal bond. *Id.* But "[b]y the end of the American Revolution, the continent was awash in colonial bonds[.]" *Id.* These "[m]unicipal securities were popular since they gave bondholders a way to share in the growth of their towns and regions." *Id.*

Municipal bonds have remained popular for more than two-and-a-half centuries. Issuances helped build "roads, canals, railroads, and waterworks" across the country—including the Erie Canal—in the nineteenth century. *Id.* Not much later, the 16th Amendment to the U.S. Constitution and the Revenue Act of 1913 gave municipal bonds another advantage by making the interest income on them tax-exempt. *Id.* The municipal market boomed through the early twentieth century, ballooning from $2 billion in issuances in 1900 to $12.8 billion in issuances in 1928. *Id.*

Municipal bonds remained a relatively safe investment even during the Great Depression, with only a 7 percent default rate during that period (as compared with a 30 percent default rate for industrial bonds). *Id.* In fact, in discussing the importance and safety of revenue bonds in 1936, A.M. Hillhouse, the Director of Research for the Municipal Finance Officers Association, noted that with revenue bonds, municipal officials "may be mandamused . . . to see that moneys received are actually applied for debt service and not diverted for general purposes." A.M. Hillhouse, Municipal Bonds: A Century of Experience, at 296 (1936).

Following the Great Depression, and over the twentieth century, municipal revenue bonds grew in popularity and use. Dr. Kenneth Durr, *The Municipal Securities Rulemaking Board Gallery on Municipal Securities Regulation—Two Centuries of Municipal Finance, Mortgaging the Future*, Securities and Exchange Commission Historical Society, http://www.sechistorical.org/museum/galleries/mun/mun02b_mortgage_future.php (last accessed Nov. 3, 2020). "[R]evenue bonds became increasingly popular because they relieved city leaders from issuing referenda *and provided investors with more certainty about the source of their proceeds*." *Id.* (emphasis added).

Buoyed by predictability over the source of repayment and their tax-exempt status, municipal "revenue bonds represented nearly half of all issue[d]" bonds by 1975. Dr. Kenneth Durr, *The Municipal Securities Rulemaking Board Gallery on Municipal Securities Regulation—Remaking the Market, Speaking to the Market*, Securities and Exchange Commission Historical Society, http://www.sechistorical.org/museum/galleries/mun/mun04a_speaking_market.php (last accessed Nov. 3, 2020).

Issuances have not slowed down. Revenue bonds are now the most common issuance by municipalities, representing 57.8% of the $3.9 trillion municipal bond market. SIFMA, *2020 Capital Markets Fact Book* at 8 (Sept. 2020) (discussing 2019 statistics).[6] Individual investors hold more than half of municipal bonds issued in the United States. *See* J. Applesom, E. Parsons, & A. F. Haughwout, *The Untold Story of Municipal Bond Defaults*, Fed. Reserve Bank of N.Y., (Aug. 15, 2012) https://libertystreeteconomics.newyorkfed.org/2012/08/the-untold-story-of-municipal-bond-defaults.html (last accessed Nov. 3, 2020).

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[6] *Available at* https://www.sifma.org/wp-content/uploads/2020/09/US-Fact-Book-2020-SIFMA.pdf (last accessed Nov. 3, 2020). This amount can fluctuate depending on how a researcher classifies revenue bonds, with some placing revenue bonds as 67 percent of the market. *See* Daniel Marques & Daniel A. Barton, BNY Mellon, *Why Municipal Revenue Over General Obligation Bonds* at 2 (Aug. 2019), *available at* https://www. mellon.com/ documents/ 264414/ 269919/ municipal-revenue-bonds.pdf/ (last accessed Nov. 3, 2020).

Simply put, the market for municipal revenue bonds is significant. In 2016, when municipalities issued more bonds than at any other time in history—an astonishing $452 billion in face amount—revenue bonds accounted for more than half those issuances ($249 billion in face amount). SIFMA, *2020 Capital Markets Fact Book* at 8 (Sept. 2020), https://www.sifma.org/wp-content/uploads/2020/09/US-Fact-Book-2020-SIFMA.pdf (last accessed Nov. 3, 2020). (last accessed Nov. 3, 2020). As of October 21, 2020, more than $2.54 trillion in municipal revenue bonds were outstanding. SIFMA, *US Municipal Revenue Bonds Outstanding* (Oct. 22, 2020). In short, as the SEC has noted, the municipal securities market, including the market for municipal revenue bonds, "now represents an increasingly important part of the U.S. capital markets." *Municipal Securities Report* at 1.

In addition to the features that make revenue bonds attractive to investors, such as stability, predictability, and reliability, revenue bonds are popular now for largely the same reasons they were popular around the time of the American Revolution. One of those reasons is that municipal revenue bonds enable investors to literally take a stake in the growth and development of towns and regions. Stated more pointedly, revenue bonds help maintain our country's competitive advantage and standard of living by facilitating municipal projects, services, and infrastructure. Congressional encouragement facilitates this competitive advantage today, through tax exemptions for municipal bonds and through special Bankruptcy Code provisions applicable to certain revenue bonds. *See* 11 U.S.C. §§ 902(2), 922, 926–928 ("*Special Revenue Provisions*"). However, these Congressional acts require courts to recognize what Congress accepted: the attachment of the revenue pledge when those revenues are collected.

Highlighting its competitive advantage, the United States contains the most extensive public works system in the world, comprised of 4,176,915 miles of roadways, 614,084 bridges, 19,636 airports, more than 25,000 miles of inland and intercoastal waterways, at least 90,000 dams, more than 2 million miles of pipe in water supply systems and 14,748 wastewater treatment plants.[7] Municipal entities provide nearly all of this infrastructure. And municipal entities must also care for it.

The American Society of Civil Engineers has estimated the cost to maintain infrastructure at a passable level will be $4.59 trillion by 2025, which is more than three times the annual tax revenues for all state and local governments. *See* Am.

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[7] *See* Bureau of Transp. Statistics, *Nat'l Transp. Statistics* (2020), https://www.bts.gov/topics/national-transportation-statistics (last visited Nov. 3, 2020); U.S. Army Corps of Eng'rs, *Nat'l Inventory of Dams* (2016), https://www.publications.usace.army.mil/Portals/76/Publications/EngineerPamphlets/EP_360-1-23.pdf?ver=2016-12-21-154355-163 (last accessed Nov. 3, 2020); U.S. Envtl. Prot. Agency, EPA 815–R–09–001, *Community Water System Survey* https://nepis.epa.gov/Exe/ZyPDF.cgi?Dockey=P1009JJI.txt (2006) (last accessed Nov. 3, 2020); Am. Soc'y of Civil Eng'rs, *Infrastructure Report Card, Wastewater*, https://www.infrastructurereportcard.org/cat-item/wastewater/ (last accessed Nov. 3, 2020).

Soc'y of Civil Eng'rs, *Infrastructure Report Card*, https://www.infrastructurereportcard.org/the-impact/economic-impact/ (2017) (last accessed Nov. 3, 2020). Inattention to our country's infrastructure needs will cause this number to increase and further deferral of needed infrastructure improvement could have devastating results.[8]

Revenue bonds will be needed to fund these improvements. And, indeed, many municipalities are currently using revenue bonds to address these types of issues. Recent revenue bond-financed projects include: revenue bonds to fund projects at the O'Hare International Airport in Chicago, Illinois, and revenue bonds issued by the City of Buffalo, New York, to fund repairs on its water system. *See* https://emma.msrb.org/P11425854-P11101285-P11510544.pdf and https://emma.msrb.org/P11426256-P11107110-P11516695.pdf (last accessed Nov. 4, 2020).

These and thousands of similar projects provide important services to the citizens of state and local governments across the country. By providing financing for these projects, revenue bonds serve a critical role in the vitality of American municipalities. This critical role requires stability and market certainty that a

[8] *See* Am. Soc'y of Civil Eng'rs, *Failure to Act: Closing the Infrastructure Investment Gap for America's Economic Future*, https://www.infrastructurereportcard.org/wp-content/uploads/2016/05/2016-FTA-Report-Close-the-Gap.pdf (2016) (last accessed Nov. 3, 2020); *see also* U.S. Census Bureau, *Quarterly Summary of State and Local Government Tax Revenue for Second Quarter 2020*, https://www.census.gov/content/dam/Census/library/publications/2020/econ/g20-qtax2.pdf (Sept. 17, 2020) (last accessed Nov. 3, 2020).

municipal pledge will not be defeated on the decision of a local government to divert pledged funds for other projects or systems. With this as a backdrop, the District Court's Opinion & Order creates significant uncertainty in the municipal revenue bond market, which can increase municipalities' borrowing costs (or reduce the financing available) and thereby cause further repair and modernization delays that municipalities can't afford.[9]

III. THE MARKET UNDERSTANDS AND EXPECTS THAT REVENUE STREAMS SECURE REVENUE BONDS

As noted above, municipalities issue two types of bonds: general obligation bonds and revenue bonds. In contrast to a general obligation bond, which a municipality secures with its full faith and credit (*i.e.*, its general taxing power), a revenue bond is secured by and repaid from a municipality's pledge of specific revenues generated from the project the bond supports (such as a municipal airport or toll road) or from a dedicated tax stream (such as a tax stream available only to build a public hospital)s. *See, e.g.*, *Municipal Securities Report* at 7 (describing the types of municipal securities); *see also, e.g.*, U.S. Sec. & Exch. Comm'n, *Municipal*

[9] While in the short-term municipalities are unlikely to see an increase in borrowing costs, any question of the security of revenue bonds could have detrimental effects to municipalities in financial distress—the very entities that bonds secured by a revenue pledge are most designed to protect.

Bonds: Understanding Credit Risk at 2 (Dec. 2012) ("Understanding Credit Risk").[10]

Revenue bonds are project specific, enabling municipalities to finance infrastructure and other improvements without saddling taxpayers with higher property taxes. They also provide financing for projects where debt limits or other restrictions imposed on municipal general-obligation financing make such debt unavailable. Because state laws typically do not permit bondholders to have a lien on a physical asset of a municipality, such as its water plant or highway system, revenue bonds are typically secured by the revenue stream derived from the project or system that the funds generated from issuing the underlying revenue bonds financed. *See, e.g.*, House Report at 4118.

In other situations, revenue bonds may be secured by a dedicated stream of tax revenues whose use may be limited to payment of the bonds in question or to the particular project—such as taxes levied specifically to pay the obligations of a public hospital district.[11] Investors rely on these dedicated tax pledges and the state-law requirements that such tax revenues will be used only as dictated by state law. These dedicated revenue streams also mean that the riskiness of a revenue bond is pegged

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[10] *Available at* https://www.sec.gov/files/municipalbondsbulletin.pdf (last accessed Nov. 3, 2020).

[11] *See, e.g.*, Cal. Health & Safety Code Ann. § 32312.

to the particular project it funds rather than to the general creditworthiness of the issuing municipality.

Because of the unique nature of revenue bonds, Congress has recognized the importance of these mechanisms and has legislated to ensure that certain revenue pledges are protected. *See, e.g.*, 11 U.S.C. §§ 902(2), 922, 926–928. Courts that have addressed revenue protections in municipal insolvencies have similarly recognized the importance of such mechanisms and Congress's intent to protect them. *See generally In re Jefferson Cnty., Ala.*, 474 B.R. 228, 263–67 (Bankr. N.D. Ala. 2012) (discussing revenue pledges and treatment of same in bankruptcy).

Thus, for long before the District Court issued its Opinion & Order, investors relied on revenue pledges for assurance that they will continue to be paid regardless of a municipality's financial distress or bankruptcy (so long as the underlying project generated sufficient revenues). Stated differently, the pledged revenue stream or dedicated tax stream secures the repayment of the principal and interest due on the bond. That security is essential because, as noted, revenue bonds are traditionally non-recourse bonds—meaning that holders usually lack the ability to pursue the taxing power or assets of the issuing municipality in the event of default. This structure additionally allows interest rates to be tied to the risk of a revenue stream rather than the strength of a municipality's coffers.

Congress has specifically acknowledged the importance and status of municipal revenue bonds in bankruptcy. House Report at 4117–4118. In 1988, Congress approved, and the president signed into law the Special Revenue Provisions of Chapter 9, the municipal bankruptcy chapter of the U.S. Bankruptcy Code. 11 U.S.C. §§ 902(2), 922, 926–28. Both the Senate and the House of Representatives issued detailed reports explaining the rationale for the Special Revenue Provisions. In fact, the House Report accompanying the Special Revenue Provisions wrote that:

> [s]pecial revenue bonds . . . are usually backed by and repaid only from the revenues generated from the physical asset built with the money raised by the bond offering. A lien in favor of the bondholders exists on this revenue stream, but not on the physical asset itself; it would violate public policy to permit the possibility of a foreclosure on a public facility. In the event of a default, bondholders cannot look to any other assets of the municipality for repayment. Only the income stream generated by the asset or the income specifically pledged as security by the municipality can be used. Special revenue bonds are issued so that if the asset financed fails, repayment will not come out of general treasury funds—meaning the taxpayer will not have to foot the bill.

House Report at 4118. Likewise, the accompanying Senate Report noted that "[r]evenue bonds generally are secured by revenues derived from the project or by a specific tax levy because applicable municipal law generally prohibits the encumbrance of municipal property with mortgages." S. Rep. No. 100–506, at 5 (Sept. 14, 1988). Congress again confirmed this understanding through its passage of § 927 of the Bankruptcy Code. 11 U.S.C. § 927. That's important here because the District Court's decision permitted the HTA and the Commonwealth to divert pledged revenues to their general funds, thus making those revenues available for other creditors in a situation where the HTA bondholders are specifically *not* permitted pursuant to § 927 of the Bankruptcy Code to receive a distribution from the HTA's general funds.

IV. THE DECISION BELOW UPENDS A LONGSTANDING, FUNDAMENTAL MARKET EXPECTATION ABOUT REVENUE BONDS

A. The Market Understands and Expects That Revenue Pledges Secure Revenue Bonds as of When the Revenues are Collected

Quite simply, the market has long understood that a municipality secures a revenue bond through a pledge of the revenue derived from the project the bond supports (or through a dedicated tax stream) as of when the revenues are collected. *See, e.g.,* Hillhouse, Municipal Bonds: A Century of Experience at 296 (noting that even in the 1930s, revenue bonds were understood to be an obligation payable out of revenues derived from a particular project). One of the preeminent bankruptcy treatises, Norton Bankruptcy Law and Practice, states simply that "[r]evenue bonds are *secured* by a pledge of a specific stream of income—most often a particular tax or fees generated by the project the bonds financed." 5 Norton Bankr. L. & Prac. § 90:13 (3d ed. 2020) ("*Norton's*") (emphasis added). Norton's goes on to state that "[s]pecial revenue bonds are the most common form of secured debt in a Chapter 9 [bankruptcy] case" and that the "lien" attaches to the relevant "revenue stream." *Id.*

Norton's is not alone in understanding that a municipality secures a revenue bond by pledging to holders the revenue stream from the project the bond supports. The Securities and Exchange Commission, for one example, consistently writes in numerous publications that revenue bonds are "backed by . . . revenues from a specific project or source[.]" *See, e.g.*, *Understanding Credit Risk*, *supra*; U.S. Sec. & Exch. Comm'n, *What are Municipal Bonds?*, https://www.investor.gov/introduction-investing/investing-basics/investment-products/bonds-or-fixed-income-products-0 (last accessed Nov. 3, 2020); U.S. Sec. & Exch. Comm'n, *Investor Bulletin: Municipal Bonds—An Overview* (Feb. 1, 2018);[12] U.S. Sec. & Exch. Comm'n, *Focus on Municipal Bonds* (Sept. 21, 2010)[13].

As another example, the Federal Industry Regulatory Authority ("FINRA") also describes revenue bonds as backed by "fees or other revenue generated or collected by a facility" or "a specific tax or assessment of a government entity[.]" FINRA, *Municipal Bonds—Important Considerations for Individual Investors*, (Apr. 23, 2013); https://www.finra.org/investors/alerts/municipal-bonds-important-considerations-individual-investors (last accessed Nov. 3, 2020). State and local

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[12] *Available at* https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins-37 (last accessed Nov. 3, 2020).

[13] *Available at* https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins/focus (last accessed Nov. 3, 2020).

government publications similarly describe the revenue stream from the project a revenue bond funds as the "security" for those bonds. *See, e.g.*, Office of the California State Treasurer, *California Bonds: 101* at 1 (2017) and Colorado General Assembly, *Funding Ideas and Sources* at 8 (Apr. 2010).[14]

In fact, legal commentators consistently describe revenue bonds as being "backed" or "secured" by pledged revenue streams arising from the underlying projects. *See, e.g.*, Gillette, *Can Public Debt Enhance Democracy?*, 50 Wm. & Mary L. Rev. at 980; Richard Briffault, *Foreward: The Disfavored Constitution: State Fiscal Limits and State Constitutional Law*, 34 Rutgers L.J. 907, 913, 918–19 (Summer 2003); Comment, *Commercial-Bank Underwriting of Municipal Revenue Bonds: A Self-Regulatory Approach*, 128 U. Pa. L. Rev. 1201, 1202 n.6 (May 1980) (citing L. Moak & A. Hillhouse, Concepts & Practices in Local Government Finance 320 (1975)).

So do financial advisors and financial advisory firms. *See, e.g.*, *Revenue Bond Security*, Morningstar, Inc., http://news.morningstar.com/classroom2/course.asp?docId=5394&page=3&CN= sample (last accessed Nov. 4, 2020) ("[R]evenue bonds are secured by specific collateral—the income produced by the projects they fund.");

[14] *Respectively available at* https://www.treasurer.ca.gov/publications/bonds101_revenue.pdf (last accessed Nov. 4, 2020) and https://leg.colorado.gov/sites/default/files/ncsc_091117_checklist_of_court_facility_funding_sources_revised.pdf (last accessed Nov. 4, 2020).

Robert W. Baird & Co. Inc., *Important Information About Municipal Bonds* at 1, 5, https://content.rwbaird.com/RWB/Content/PDF/Help/Important-info-Municipal-Bonds.pdf (2020) (last accessed Nov. 4, 2020); Cooper Howard, *Understanding Municipal Revenue Bonds*, Charles Schwab, https://www.schwab.com/resource-center/insights/content/under standing-revenue-bonds (Sept. 12, 2019) ("Most revenue bonds are backed by a . . . pledge on the enterprise's revenue.").

And, here, the HTA and the Commonwealth recognized the same in Official Statements accompanying the issuance of HTA bonds. *Puerto Rico Highways and Transportation Authority, Highway and Transportation Revenue Refunding Bonds* at Cover Page, 14, *available at* https://emma.msrb.org/EP747274.pdf (last accessed Nov. 4, 2020) (the "*HTA Official Statement*").

B. Upholding the Decision Below Will Upset the Market

At no point have any of these market participants (with the exception of the HTA and the Commonwealth) contemplated that a revenue pledge would not attach *until* the revenues at issue were transferred by a municipal obligor to a bond trustee or paying agent. And yet, the District Court ignored and split from this market consensus and the considerable authorities that share the same understanding of how revenue bonds work. In relevant part, it found that holders of HTA's municipal revenue bonds lacked an interest in pledged revenues unless and until those revenues were deposited in the accounts of the fiscal agent who pays the bonds. *See, e.g.*, Opinion & Order at 24–33. Stated differently, the District Court limited the HTA Bond Resolution revenue pledge to funds *already received* by the fiscal agent.[15]

In this sense, the District Court's Order and Opinion permits a bait-and-switch: it enables the HTA and Puerto Rico to deprive bondholders of pledged revenues, including toll revenues and pledged tax revenues, by diverting them from the account from which bondholders are paid. The municipal revenue bond market, however, takes as a basic premise that bondholders obtain enforceable property rights on the pledged revenue streams arising from the projects the bonds finance. If the municipal market would have contemplated that a municipal obligor could defeat bondholders' liens by simply failing to transfer pledged revenues, or by repurposing those pledged revenues or taxes for another project, it would not enjoy the stability and low cost of financing that exists in it today. Put differently, the market that municipalities have relied on to dig out of bad times and function in good times could be considerably chilled. That's especially so for distressed municipalities who may need this market the most. The District Court's decision could therefore cause investors to treat revenue bonds and general obligation bonds similarly, increasing borrowing costs for those municipalities (including the distressed municipalities most in need of financing).

[15] This conclusion also disregards the plain text of the bond resolutions and the Official Statement.

The decision below thus upends fundamental, longstanding, well-settled expectation about the security that assures municipal revenue-bond investors that they will be repaid—to say nothing of general rule-of-law concerns about the need to enforce parties' bargains as written and understood. The uncertainty that the District Court's Opinion & Order could send across the $2.54 trillion municipal revenue bond market may cause investors to seek better terms from municipalities (especially those with the greatest risk of nonpayment), thereby increasing municipalities' borrowing costs (if not decreasing the financing available to them). In other words, municipalities may have to pay bondholders for perceived risk caused by the Order and Opinion where before they would not. To be sure, it will be the municipalities in most need of financing that will feel these effects the hardest.

What's more, the current economic climate will exacerbate the reaction to the District Court's Opinion & Order. Earlier this year, the municipal bond market saw "extreme" volatility. Cooper Howard, *Coronavirus and the Municipal Bond Market: Questions and Answers*, Charles Schwab (Apr. 1, 2020).[16] One factor that contributed to that volatility was a lack of liquidity—investors could not get a reasonable price for their bonds. *Id.* And even before that, the Wall Street Journal reported that bond ratings struggled to reflect the value of the instrument. Gunjan

[16] *Available at* https://www.schwab.com/resource-center/insights/content/coronavirus-and-municipal-bond-market-questions-and-answers (last accessed Nov. 4, 2020).

Banerji, *Muni-Bond Ratings are all Over the Place. Here's Why.*, The Wall Street Journal, https://www.wsj.com/articles/muni-bond-ratings-are-all-over-the-place-heres-why-11575628200 (Dec. 6, 2019) (last accessed Nov. 4, 2020). Notably, the Wall Street Journal reported that the treatment of municipal bonds in this case, at the trial court, contributed to this difficulty. *Id.* Questions about the fundamental nature of municipal revenue bonds in light of the District Court's Opinion & Order below will complicate these issues by magnitudes.

More specifically, the market is at risk of losing some of its relative stability, and the distinction between municipal revenue and general obligation bonds will be blurred, if the Court were to uphold the Opinion & Order. Consider how the market reacted to what happened in this case before. After this Court affirmed the District Court's decision denying claims for turnover of special revenue under §§ 922(d) and 928(a) of the Bankruptcy Code, *In re The Fin. Oversight & Mgmt. Bd. for Puerto Rico, as representative of The Commonwealth of Puerto Rico*, 919 F.3d 121, 124 (1st Cir. 2019) (the "Puerto Rico I Decision"), at least one ratings agency placed seven U.S. public finance ratings on "Rating Watch Negative." Fitch Ratings, *Fitch Places Seven USPF Special Revenue Ratings on Negative Watch Pending Court Decision* (Apr. 11, 2019) https://www.fitchratings.com/research/us-public-finance/fitch-places-seven-uspf-special-revenue-ratings-on-negative-watch-pending-court-decision-11-04-2019 (last accessed Nov. 4, 2020).

In making this placement, Fitch noted that the affirmance and underlying decision were "inconsistent with Fitch's and market participants' general understanding" of Chapter 9's Special Revenue Provisions. *Id.* Moody's, too, downgraded bonds from the Illinois State Toll Highway Authority and Cleveland Water in light of the Puerto Rico I Decision.[17] This was because these ratings agencies determined after the Puerto Rico I Decision that revenue bond ratings should be tied more closely to the ratings of a municipality's general obligation bond debt due to the increased risk created by the Puerto Rico I Decision to investors.[18]

Despite these downgrades and warnings, ratings reports and research issued after the Puerto Rico I Decision never questioned the security of municipal revenue bonds. What stabilized the market in light of the Puerto Rico I Decision was the persistent understanding that municipal revenue bonds are secured. The District

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[17] *See, e.g.*, Yvette Shields, *Illinois Tollway Takes a Rating Blow in Puerto-Rico Related Fallout*, The Bond Buyer, https://www.bondbuyer.com/news/illinois-tollway-takes-a-rating-blow-in-puerto-rico-related-fallout (last accessed Nov. 4, 2020); Nora Colomer, *Why a Cleveland Rating Took Collateral Damage from Puerto Rico*, https://www.bondbuyer.com/news/cleveland-water-revenue-bonds-take-puerto-rico-related-downgrade (last accessed Nov. 4, 2020).

[18] Market participants have noted that, following the Puerto Rico I Decision, ratings agencies revised their criteria for priority lien and special revenue bonds, and therefore advised that "greater investor due diligence is warranted for special revenue bonds." Peter DeGroot & Daniel Zheng, *Municipal Markets Weekly* at 10, J.P. Morgan—N. Am. Fixed Income Strategy (May 3, 2019); Peter DeGroot & Daniel Zheng, *Municipal Markets Weekly* at 19, J.P. Morgan—N. Am. Fixed Income Strategy, 19–23 (Apr. 26, 2019).

Court's Opinion & Order, in stark contrast, questions the very fact of repayment from pledge revenues, blurring (and possibly worse) the line between municipal revenue and general obligation bonds. The Opinion & Order, if affirmed, would strike a much more fundamental blow to the municipal revenue bond market by changing the basic economics of those instruments, thereby increasing borrowing costs for municipalities.

Data points and analyses described above indicate that the municipal revenue bond market may be balanced on a precipice, ready to totter one way or the other. Where the market was initially shocked by the Puerto Rico I Decision and its treatment of the procedure for repayment of municipal revenue bonds under Chapter 9 of the U.S. Bankruptcy Code, the District Court Opinion & Order goes farther by calling into question the very fact of repayment of those bonds. It therefore blurs most, if not all, distinctions between municipal revenue and general obligation bonds. The District Court's Opinion & Order, if affirmed, therefore risks shoving the municipal revenue bond market off the precipice on which it is balanced—with issuers paying the price. The Court should not let that Opinion & Order stand.

CONCLUSION

For the reasons described above and in Appellants' Opening Briefs, the Court should reverse the District Court's Opinion & Order.

Date: November 4, 2020

RESPECTFULLY SUBMITTED,

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<u>CERTIFICATE OF COMPLIANCE</u>

Pursuant to Federal Rule of Appellate Procedure 32(g), I certify that this brief complies with the type-volume limitation of Federal Rule of Appellate Procedure 29(a)(5) because it contains 5,738 words. I further certify that this brief complies with the typeface and type style requirements of Federal Rule of Appellate Procedure 32(a)(5)–(6) because it has been prepared in a proportionately spaced typeface using Times New Roman 14–point font.

Date: November 4, 2020

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CERTIFICATE OF SERVICE

I hereby certify that on November 4, 2020, I electronically filed the foregoing with the Clerk of the Court for the United States Court of Appeals for the First Circuit by using the appellate CM/ECF system. Participants in the case who are registered CM/ECF users will be served by the appellate CM/ECF system.

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